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Robert G. Speidel

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Executive Compensation and the Tax Reform Act of 1969—A Game with a New Set of Rules

by ROBERT G. SPEIDEL
Partner, Pittsburgh Office

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ONE OF THE AREAS of tax planning in which the 1969 Tax Reform Act could have its greatest impact is that of compensating corporate executives. It seems to me that we really need to take a new look at some of the executive compensation patterns that have developed over the years. We may find many plans tailored to meet objectives no longer so important as they once were.

- For example, an important element of many plans has been to provide capital gains potential through stock options and the like. Perhaps we have now reached the point where the advantage of capital gain income as compared with ordinary income is not enough to offset the disadvantages of some of the plans designed to give capital gains potential.
- Also, many compensation plans are designed to defer for a period of years or until retirement the time at which compensation income is received and taxed. Here again, we may find that the advantage of doing this is not nearly so important as it once was.

CHANGES AFFECTING FUTURE PATTERNS

Before analyzing their effects, let us just recap briefly some of the 1969 Act changes that will influence the future pattern of executive compensation plans.

- The most important change, in my view, is the new 50% maximum tax rate on earned income, starting in 1972. The maximum for 1971 is 60%. Deferred compensation is not eligible for this 50% maximum rate. Also, the amount eligible for the maximum rate can be reduced by so-called tax preference items such as the bargain element on the exercise of stock options and the excluded portion of capital gains.

- Other changes that may directly or indirectly effect compensation patterns are:
 - .. The maximum tax rate for capital gains over \$50,000 goes from 25% to 35% by 1972. Thus, the rate differential on large capital gains, as compared with earned income is only 15 points as compared with a possible 45 points under the old law.
 - .. The income-averaging rules have been liberalized. Starting in 1970, averaging will be permitted when the differential between current income and base-period income is more than 20%. Previously, a 33-1/3% differential was required before averaging could be applied. This has the effect of softening the tax impact upon the receipt of large amounts of ordinary income.
 - .. When an employee receives a lump-sum distribution of benefits from a qualified employee trust upon termination of employment, under the new law a portion can be taxed as ordinary income rather than as capital gain. The ordinary income portion will be limited to employer contributions after 1969. There is, however, a special seven-year averaging provision, which will soften the effect of treating the lump-sum payment as ordinary income.
 - .. The tax treatment of restricted stock plans has been changed quite drastically. Generally speaking, under the new law, property transferred to an employee becomes taxable to him at its full value at the time the employee's rights to the property become nonforfeitable. The taxable value is measured without regard to any restrictions to which the property is subject unless the restriction is one that by its terms will never lapse. Under the general rule, the employee can no longer avoid reporting taxable compensation income on any increase in the value of the property during his period of restricted ownership. Under an exception to the general rule, however, an employee can elect to recognize income at the time property is transferred to him, even though his rights are forfeitable. If he makes this election and the property increases in value, the increase is not taxed as compensation to

him. The disadvantage is that the employee gets no offsetting deduction if he does forfeit the property.

MAXIMUM TAX ON EARNED INCOME

As mentioned before, I think that the provision limiting the tax rate on earned income to 50% is the one that will have the greatest long-range effect on executive compensation programs. What it will mean, I think, is that current cash, as a means of executive compensation, will be back in style. The over-all effect should be a healthy one: Executive compensation programs should become simpler and companies can more readily reward their executives currently for the value of their current services.

If an executive's performance in a particular year warrants a special bonus of say \$200,000, then the company can pay this to the executive with the knowledge that at least half of the bonus will end up in the executive's pocket. I think it is important to note also that the 50% maximum tax rate effectively eliminates the government as a partner in the relationship between the executive and his employer. Generally speaking, the corporate employer's after-tax cost on the payment of executive compensation is about half of the amount paid. Under the new law, the net after-tax yield to the employee will also be not less than 50%. Under the regular tax structure, where the top rate on income is 70%, there can be as much as a 20% net tax bite taken out of the over-all compensation transaction.

One interesting sidelight here is that the new provision might add a new dimension to our struggles with IRS agents on the reasonableness of compensation. Until now we have been concerned mostly with the effect of the salary disallowance on the employer's deduction. Under the new law we shall also have to concern ourselves with a possible additional tax to the employee if part of his salary is considered to be unreasonable compensation.

Let us get a little more specific now as to how this maximum tax on earned income works. The tax computation is made in three steps. Assume that the computation is being made for 1972 when the maximum rate goes to 50%.

- First the tax is calculated on the highest amount of taxable income on which the marginal rate is less than 50%. For a taxpayer filing a joint return this would be \$52,000.

- Next, compute the tax at 50% on the earned income in excess of \$52,000. The figure used here would in effect be reduced by a pro rata portion of the itemized deductions and exemptions. It is also reduced by the total of the so-called tax preference items in excess of \$30,000.
- The third step is to compute the tax on the remainder of the taxable income at the rate bracket in which it would be taxed if there were no limitation.

The effect of this is that an employee can receive any amount of earned income and it is never taxed at a rate of more than 50%. If the individual happens to have a large amount of other income, however, the receipt of additional earned income can cause the other income to be taxed in a higher rate bracket. An executive with substantial income-producing property may find it advantageous to transfer some of this property to a short-term trust to be held during the years he expects to receive large amounts of earned income.

For purposes of the new rate ceilings, the term "earned income" has the same meaning as in section 911 (b), which relates to income from sources outside the U.S. It includes wages, salaries, professional fees and other amounts received as compensation for services actually rendered. As to professional fees, the entire amount of the fee is earned income even though part of the services are performed by employees of the taxpayer, provided that the taxpayer is responsible for the services performed. If the taxpayer is engaged in a trade or business in which both services and capital are material income-producing factors, the amount considered to be earned income cannot exceed 30% of the taxpayer's share of the profits. The regulations and the cases under section 911 seem to give us very little guidance as to the situations under which capital is considered to be a material income-producing factor. This can be very important under the new law because it is almost an all or nothing situation. If capital is not an important income-producing factor, then all the income is eligible for the 50% rate; on the other hand, if capital is an important factor, then no more than 30% of the income qualifies for the 50% rate.

Amounts received under plans having the effect of deferring the receipt of compensation as described in section 404 are not eligible for the maximum rate. There is, however, a rather significant exception to this where the compensation is deferred subject to a substantial risk of for-

feiture—for example, where the payment is conditioned upon the employee's remaining with the company. In these cases, if the employee receives the compensation by the end of the year following the year in which the payment became nonforfeitable, then the compensation is eligible for the maximum 50% rates. As you know, it's relatively common in an executive compensation plan for the payout to be made in instalments over a period of four or five years. The 50% maximum rate for these plans will apply as long as payment is conditioned on the employee's "earning out" the bonus instalments by remaining with the company.

EFFECT ON QUALIFIED STOCK OPTIONS

It seems to me that another effect of the 1969 Tax Reform Act may be to reduce very seriously the effectiveness of the qualified stock option as a means of compensating corporate executives. If the state of the stock market has not already killed the stock option, then the Tax Reform Act might. There are two main reasons for this:

- For one, as mentioned before, the increase in the capital gains rate and the decrease in the maximum rate on earned income will eventually reduce the spread between the two rates to as little as 15 points. This perhaps is not enough of a difference to offset the inherent disadvantages of the qualified stock option.
- Also, under the new law, the bargain element upon the exercise of a qualified stock option (that is, the excess of the stock value at time of exercise over the price paid) is classed as a tax preference item. If later the option stock is sold, the excluded half of any long-term capital gain is also a tax preference item. These tax-preference items are subject to a 10% minimum tax. For most executives, this will not be a serious problem because the amount subject to the minimum tax is reduced by a \$30,000 exemption plus the federal income tax for the year. The total of these tax preference items, however, to the extent it exceeds \$30,000, also reduces the amount of earned income subject to the 50% minimum tax rate. The impact of this on the corporate executive could be significant. In fact, there could be situations in which the after-tax yield to the executive upon the exercise and sale of stock under a qualified stock option plan could be less than if he were to receive the equivalent in cash as ordinary income.

Example:

- Corporate executive with compensation of \$450,000 a year is granted a stock option of \$300,000.
- When he exercises the stock option, the stock is worth \$500,000.
- In year of exercise, he would have tax-preference income of \$200,000. This would reduce his income subject to the 50% maximum by \$170,000 and would cause an increase of about \$34,000 in his tax for that year.
- Three years later, if he sells the stock for a profit of \$200,000 he would have a tax of \$65,000 on the capital gains (\$12,500 on \$50,000 and \$52,500 on \$150,000). He would also have a tax-preference item of \$100,000 ($1/2$ of \$200,000), which would cause a further increase of \$14,000 in his tax.
- Thus his effective tax on the \$200,000 bargain element in the stock option is \$34,000 in the year of exercise, plus \$65,000 and \$14,000 in year of sale or a total of \$113,000—an effective rate of about 57%.
- This of course is more than the 50% tax that would be payable if the \$200,000 had been paid in cash. Additionally, the executive has been required to put \$300,000 at risk for at least three years. His interest cost for financing the stock purchase for the three-year period would in most cases be substantially more than the stock would yield in dividends.
- Add to this the fact that the company must give up its tax deduction in order to allow long-term capital gain treatment of the executive and it is difficult to see the advantage of continuing a qualified stock option program on anything like the scale on which they have been used in the past.

In my view, the over-all effect of the Tax Reform Act has been to limit seriously the value of the qualified stock option as an executive compensation tool. Also, the Act very seriously reduces the effectiveness of the so-called restricted stock plans, which had become so popular in the last few years. I do not think it is a complete answer to say that the alternative to these stock plans is to give the executive more cash. Plans providing for only current cash payments seem to me to lack one element that is important to attract and retain competent top-level executives.

This element is the knowledge on the part of the executive that as he succeeds and as the company prospers, he will be able to build a substantial estate for himself and his family. Even with the government's tax-take limited to 50%, it would seem to me very difficult to devise a system of cash bonuses which will give the executive the feeling that the growth of his personal wealth will be tied into the growth in the company's value under his guidance.

NON-QUALIFIED STOCK OPTIONS

Now that the Tax Reform Act has dulled some of the glamour of the qualified stock option, we are likely to see an increased use of non-qualified stock options by corporate employers. The terms of non-qualified options need not fit into the restrictive requirements of the Internal Revenue Code; this gives corporations more flexibility in setting the terms of the options to meet the needs and objectives of both the corporation and its executives.

Generally speaking, an executive is taxed at ordinary income tax rates on the spread between the option price and the value of the stock at the date the option is exercised. The income taxed to the executive would, in most cases, qualify for the 50% maximum tax rates and will not be treated as tax-preference income. The corporation will be entitled to deduct, in its return, the same amount that is taxed to the executive. Under a non-qualified plan, the corporation can often make the terms of the award more attractive to the executive by structuring the plan to pass all or part of the corporate tax benefit along to the executive.

PHANTOM STOCK PLANS

Another possible way of giving the executive the ability to build an estate is through some version of the so-called phantom stock plans, which in the past have achieved only limited popularity. Under these plans, the executive is credited with units, the value of which is related to hypothetical shares of the company's stock. As the value of the company's stock increases, the value of the hypothetical shares credited to the executive also increases. Ultimately an amount equivalent to the appreciation in the value of the hypothetical shares is paid out to the executive; payment is often made over a period of years after retirement. The

executive is taxed at ordinary income rates on these payments, but since the payments are often received after retirement, the tax burden is not so great. The employer can deduct the payments as compensation at the time they are made. So far as I can tell, the Tax Reform Act will have little or no effect on the tax status of this type of plan. So long as the executive's rights to receive compensation are forfeitable when credited to his account and so long as the obligation to the executive is not set aside in a separate fund and thereby insulated from the claims of creditors, the executive should not be subject to tax on the compensation until he receives the payments. The payments to the executive will probably not qualify for the 50% maximum rate, but this should not normally be a significant disadvantage once the executive has retired.

One of the major disadvantages of this type of plan to the executive is that he has no tangible evidence of the value of his right to receive compensation. He assumes the risk that the employer will be able to pay the compensation when it is due.

AN EXECUTIVE COMPENSATION TECHNIQUE

Just recently I have been thinking about another executive compensation technique that might offer a way of giving the corporate executive an estate-building potential without exposing him to the risks and other disadvantages of a qualified stock option plan. I have been considering the possibility of a company's creating a new issue of convertible preferred stock especially for use in paying compensation to its executives.

As an example, assume a convertible preferred stock which is redeemable and callable at \$50 a share after fifteen years and which pays an annual dividend of 50 cents a share. Assume that each share is convertible into four shares of common after five years and that the common stock is selling for \$15 a share. The preferred stock could be non-transferable and could be subject to sale back to the company at a reduced amount if the executive terminates employment before a specified period of time.

Let us assume that the company obtains expert opinion that the fair market value of this stock is equal to \$35 a share. The investment value of a 50 cent redeemable preferred stock to yield 8% for fifteen years might be about \$20 a share. For illustration purposes, I have assumed that the

conversion privilege would add another \$15 in value. The conversion terms could be altered to arrive at whatever value was desired.

Assume that a particular executive received as a bonus 200 shares of this stock, and it is valued at \$7,000 without regard to the restrictions. Under the restricted stock provisions of the Tax Reform Act (section 83b), he could elect to include this \$7,000 in income immediately and the maximum tax he would pay on it would be \$3,500. Let us say that this executive performed well, the company prospered, and after five years the market value of the common stock had increased from \$15 to \$40 a share. He could convert his 200 shares of preferred into 800 shares of common worth \$32,000. He has a potential capital gain of \$25,000 and he has developed an asset of \$32,000 for his estate at a tax cost of no more than \$3,500.

On the other hand, if the value of the common stock remained relatively stagnant, the executive could redeem his stock for \$10,000 after fifteen years. The executive is subject to very little downside risk, while the potential on the upside is unlimited. The executive is also freed from the financing burdens of a stock option plan, and the only exposure to tax preference income would be on the 50% capital gains exclusion if the stock was sold.

CONCLUSION

To conclude, I think that the provisions of Tax Reform Act relating to executive compensation offer some very interesting possibilities for the tax planner to explore. The new rules, it seems to me, lend themselves more readily than the old rules to the development of a plan offering realistic after-tax rewards to the successful executive.

